Broadening Hong Kong's Tax Base

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Hong Kong Institute of
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Submission on the government's consultation document:

Broadening the Tax Base, Ensuring our Future Prosperity – What's the Best Option for Hong Kong?

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Executive Summary

Introduction

1. Following the release of the government consultation document, *Broadening the Tax Base - What's the Best Option for Hong Kong* in July 2006, the Institute conducted members' forums and set up a working group (the Working Group on Tax Reform ('working group"), originally called the GST Working Group) under the Taxation Committee to prepare the Institute's response, and also to help inform members about the main issues in the debate surrounding a goods and services tax ("GST") and to canvass views from members. The working group launched a dedicated website and issued a series of e-letters to members addressing key issues in the debate on reform of the tax base and a GST and inviting views on those issues through the website. In November 2006, the Institute commissioned an independent market research company to conduct a members' survey on broadening the tax base and a GST.

2. On 5 December 2006, the government published an Interim Report on the consultation and the Financial Secretary ("FS") announced that, in the light of the generally negative response to the consultation proposals, for the remainder of the period of public consultation until 31 March 2007, the government would not be advocating GST as the only or the main option to broaden the tax base.

3. The Institute subsequently held a members' forum on 11 December 2006 attended by the FS at which views were exchanged on other options. Shortly thereafter, on 14 December 2006, the Institute announced the results of its members' survey and submitted a summary of the survey results to the government. We also indicated that a further submission on the consultation document would be made in due course, which would examine a range of options for reform of the tax base. Since then, the working group has been working on a revised submission taking into account the change in the government's position.

4. The submission comprises two main parts: Part A looks at options other than a GST to broaden the tax base, while Part B considers the GST option. The detailed format is governed by the key questions contained in the government's consultation document, which the submission answers in the order in which they appear. The full results of the Institute's survey of members, which provides more information on the response to detailed GST-related questions than the summary sent to the FS in December 2006 are appended to the submission.

The submission

5. Having examined a number of different options to broaden Hong Kong's tax base, the Institute concludes that, prima facie, there is no option that, by itself, would be better able than a GST to meet the objectives of broadening the tax base, reducing volatility in revenues, causing minimal economic distortions, achieving a substantial yield at relatively low rates of tax, etc. However, if a GST is not to be pursued, there are other options that merit further study.

Part A

6. In Part A, the submission examines the following options:

- increasing rates of salaries tax and profits tax
- decreasing personal allowances
- payroll and social security taxes
- poll taxes
- increasing rates on tenements
- increasing stamp duty on property
- increasing stamp duty on stock transactions
- capital gains taxes
- taxation of interest income
- dividend tax
- tax on worldwide income
- wholesale or retail sales taxes
- air, land and sea departure tax
- taxes on mobile phones and signboards
- selective consumption taxes
- import/export levy
- financial transactions tax
- environmental or green taxes
- surcharge on utility supplies

7. For a variety of reasons, many of the above options were found to be unsuitable; for example, they continue to rely on the same narrow tax base and on direct taxation; they are too volatile or too easy to avoid; they conflict with the existing simple tax system because, for example, definitional and other technical difficulties would make them complex; they would provide a low yield (e.g., because Hong Kong taxes according to the source principle, so revenue from an overseas source would be non-taxable); the potential downside, possibly combined with other of the afore-mentioned factors make them unappealing.

8. Nevertheless, the Institute suggests that, in the absence of GST, certain options, mainly those indicated below, should be examined in more detail, either on their own, or as part of package of measures that together could achieve a yield of a similar order to a GST. These options are not without disadvantages, which we note.

- Payroll and social security taxes: Such taxes are fairly common overseas. This is a broad based form of tax and, if introduced in Hong Kong, could give more people a direct and visible stake in Hong Kong's future economic and social development. On the downside, such taxes would not reduce reliance on direct taxation. The Advisory Committee of New Broad-based Taxes ("Advisory Committee") calculated that each 1% in the form of a payroll tax would generate $5.8 billion annually.

- Increasing rates on tenements: The Advisory Committee noted that "rates do provide a broadly-based stable source of revenue that is relatively less affected by cyclical movements in business profits and, to a significantly lesser extent personal incomes. Rates are very much broader-based that either profits tax or salaries tax…. The mechanism to increase rates is simple and an increase in the level of rates generates meaningful additional revenue". However, the disadvantage is that Hong Kong already relies heavily on property-related taxes and a significant increase in rates might be a disincentive to businesses locating here.

- Increasing stamp duty on stock transactions: The duty currently stands at 0.2% per transaction shared between the vendor and the purchaser. While the trend internationally may be to reduce this form of taxation, Hong Kong can be distinguished from other markets as it has no capital gains taxes, no dividend tax, limited withholding taxes, etc. The growth in revenue from this source is due in part to the increase in market turnover resulting from Hong Kong's status as a capital-raising centre for Mainland enterprises. Stamp duty on stock and real property transactions in 2006/07 increased from an original estimate of HK$14.8 billion to a revised estimate as at 1 March 2007 of HK$23.4 billion. Much of that increase is believed to be from stock transactions. This form of taxation is quite broad based given the strong retail element in Hong Kong's securities market. On the downside, this will inevitably remain a relatively volatile source of revenue.

- Single stage retail sales tax ("RST"): RSTs have in the past been fairly common and they still operate in most of the individual states of the United States. A single-stage RST would be broad based and could be less complex than GST, particularly if charged on presumptive rather than individual transaction basis. At the same time, it would not have the self-checking feature of a multi-stage consumption tax, it could be seen as regressive in the same way as GST, and could give rise to disputes between taxable entities and the tax authorities, where retail sales form only part of a firm's business.

- Air, land and sea departure tax, in particular a tax on land crossings between Hong Kong and the Mainland: This form of tax was under consideration for several years, although the proposal was eventually dropped by the government. Such a tax would be broad based and, in our view, equitable. On the other hand, at a rate of about HK$20 per crossing to the Mainland, it would raise only around HK$2 billion and, were numerous exemptions to be given, e.g. to people who cross the boundary on a daily or frequent basis, the tax would become more complex to administer, more selective and less broad based.

- Environmental or green taxes: Revenue from environmentally related taxes averages roughly 2% of GDP in OECD member countries. This would amount to around HK$30 billion were Hong Kong to achieve the same, whereas we estimate that, in 2005/06, the actual figure was less than 1% in Hong Kong. While we recommend that a feasibility study should be carried out on introducing a comprehensive green tax regime in Hong Kong, green taxation would not provide an ideal alternative to a consumption tax, as the yield would be uncertain and the issue is complicated by the social policy objectives that would be inherent in any system of environmental taxation.

- Surcharge on utility supplies: A surcharge on utility supplies, such as gas and electricity, could be easily calculated and conveniently collected by the utility companies on behalf of the tax authorities. It would also be broadly based but, at a low rate, it would not generate large amounts of revenue. Based on the published accounts of electricity and gas companies for the year ended 31 December 2005, a levy of 5% would generate tax revenues HK$2.25 billion and each percentage of tax (levied on turnover) would generate between HK$450 million and HK$475 million.

- Dividend tax: A dividend tax may also be worth considering, although, on balance, it may well be that the disadvantages would outweigh the advantages. This would be the case particularly if the proposal were to involve an imputation system, to credit the recipient with the corporate tax paid on the profits from which the dividend derives.

Part B

9. Part B of the submission looks at a GST in the light of the reaction from the community and the findings of the survey of members of the Institute. The framework and design features proposed in the consultation document, such as exemptions, compensatory and assistance measures to households and businesses, are examined and commented upon.

10. While at the macro level, the Institute is broadly supportive of the framework proposed in the consultation document (which incorporates a number of the design features advocated by the Institute in a GST system), the main conclusion in this part of the submission is that, if the government is to revive the GST proposal in the future, then various issues need to be addressed which have not been covered in the current proposals or not in sufficient depth to remove the considerable uncertainties. These issues include:

    - The lessons that should be learned from jurisdictions where a GST has been implemented fairly smoothly and also from problem implementations

    - A commitment should be given to conduct more detailed economic and fiscal modelling and forecasting to test any proposed system

    - Concerns expressed by the community during the consultation need to be addressed in greater depth, such as the impact of a GST on low- and fixed-income groups, including retirees and on Hong Kong's competitiveness

    - More emphasis needs to be placed on education and information in the first instance, e.g., how moving away from direct taxation towards more indirect taxation provides the individual with greater choice and can encourage both saving and investment

      Consideration needs to be given to the type of GST system that might be more acceptable in Hong Kong. As the main objective at the outset is not to raise revenue, it could be introduced at a lower rate (e.g., 3%). Were a policy of minimal exemptions and zero-rated items to be adopted, more work would need to be done to explain the rationale to the community, and a review of the adequacy of the compensation package would need to be conducted, which would take account of e.g., the impact of taxing basic services

- More information is needed about the real costs to small and medium-sized businesses where they voluntarily register, and the implications for them where they do not register

- More information should be provided on the impact on the import/export trade

- Information should be provided as to the pre-GST educational programmes and pre- and post-GST support services that would be available to help manage the transition

- Answers should be given to questions about administration, both structural (e.g., who would administer the tax and how would staff be trained? Matters relating to investigation and enforcement and dispute resolution) and procedural (e.g., impact of group transactions and arrangements for bad debt relief).

11. In terms of the economic and industry sector impacts, the Institute feels that the direct and indirect impacts of the introduction of a GST in Hong Kong may have been underestimated in the proposals.

12. As regards returning the additional funds raised from GST back to the community, in principle the Institute supports reductions in profits and salaries taxes. However, the submission makes the point that the introduction of a GST should be part of a cohesive package of tax reforms, which should include incentives for business and offsetting benefits for different groups of taxpayers (including the middle income group) and for low income earners. A study on Hong Kong's competitiveness should be conducted to determine the most appropriate package of measures to maximise benefits to the overall economy.

PART A

Broadening the Tax Base – Options Other than a Goods and Services Tax

Introduction

1. Discussion about broadening the tax base has been taking place in Hong Kong for the past two decades. In the late 1980s, the Financial Secretary ("FS") expressed concern that too much reliance was being placed on direct taxation, resulting in considerable volatility in revenues. It was argued that there needed to be a better balance between direct and indirect taxation. A consultative paper on introducing a sales tax in Hong Kong was issued in 1989. However, due to public opposition, the proposal did not proceed at that time.

2. It is common knowledge that the bulk of tax revenue from profits and salaries tax is paid by a very small proportion of taxpayers, and that revenues from land premiums and land related taxes, such as stamp duty, which are also volatile, form another significant part of government income. The instability of the fiscal structure came to a head during the Asian financial crisis. During 1998/99 to 2003/04, there were deficits in the consolidated account in five out of six years, peaking at deficits of $63.3b in 2001/02, $61.6b in 2002/03 and $40.1b in 2003/04.

3. The Institute highlighted the problem in its 2000/2001 budget proposals submitted to the FS in November 1999 and entitled, *Taxation in the 21 Century – The Case for a Fundamental Review*. In this submission, we drew attention to the narrowness of Hong Kong's tax base, suggested that the need to broaden the base was one of the key issues that needed to be addressed in a general review of the tax regime. Some specific options were also discussed.

4. Subsequently, the government established the Advisory Committee on New Broad-based Taxes ("Advisory Committee"), which during 2001-2002 conducted a public consultation on measures to broaden the tax base.

5. The government also set up the Task Force on Review of Public Finances ("Task Force"), tasked with investigating whether the series of fiscal deficits, which occurred at the end of the 1990s and into the new millennium, were cyclical or structural in nature. The Task Force issued its report in 2002. On the structural versus cyclical question, the report concluded:

> *"The Task Force finds that Hong Kong is facing an ongoing and persistent fiscal problem. Some of the economic forces leading to this situation are believed to be structural in nature, although it is difficult, if not impossible, to discount the effects of all the cyclical factors…"*

6. The Task Force went on to say that the recommendations of the Advisory Committee, which was to report shortly afterwards, should be carefully considered when the economic situation permitted.

7. In its final report to the FS, the Advisory Committee reviewed a number of different options and found that: “a GST [goods and services tax] is the only new tax with the long-term capacity to broaden the tax base which is not incompatible with Hong Kong’s external competitiveness.” The Advisory Committee also recommended that, “a policy decision to implement a GST or not should be taken as soon as possible”, given the lead-time required for legislation and other preparatory work. From the political standpoint, the final report also acknowledged that there was never a popular time to introduce new taxes.

8. The Institute returned to this theme on several occasions, including in its submission on the consultation document issued by the Advisory Committee and in subsequent budget submissions to the FS, and called for a decision to be taken on the way forward following a full public consultation.

9. The government launched the current consultation in July 2006. The proposals contained in the consultation document, “*Broadening the Tax Base Ensuring our Future Prosperity – What’s the Best Option for Hong Kong?*”, focus primarily on the option of a GST. The Institute responded by conducting members’ forums and setting up a working group to gather views and prepare a submission. The working group (the Working Group on Tax Reform (“working group”), originally called the GST Working Group) launched a dedicated website to inform members about the background to the subject and to solicit feedback. It also issued a series of e-letters to members addressing key issues in the debate on reform of the tax base and a GST and inviting views on those issues through the website. Taking account of the initial feedback from members, in November 2006, the Institute commissioned an independent market research company to conduct a members’ survey on broadening the tax base and a GST.

10. Following a generally negative initial public reaction to the proposals, some people called for the government consultation to be curtailed. The Institute, however, remained supportive of the government’s decision to continue with the consultation exercise at that point and to allow all sectors of the community to express a view. However, on 5 December 2006, the FS announced that, in view of the negative public reaction to the specific proposals for a GST, for the remainder of the consultation period (until the end of March 2007) the government would not be advocating GST as the only or the main option and that views on other options were welcome. An Interim Report was also published which explained the position in more detail. On 11 December, the Institute organised a further members’ forum attended by the FS, at which views were exchanged on different options to broaden the tax base.

11. On 14 December 2006, the Institute held a media briefing to announce the results of its members’ survey and wrote to the government to convey the findings survey and to pass on a summary report. The Institute also explained a further submission would be made, which would examine a range of options for broadening the tax base.

12. Against the above background, and in the light of the announcement on 5 December 2006, we propose in this submission to consider various options for broadening the tax base in Hong Kong. Non-GST options are considered in Part A while GST is considered in Part B.

13. In considering the options, we set out our response to the key questions raised in each chapter of the government's consultation document. Where appropriate, we also refer to the findings of the Institute's members' survey (see **Appendix 5**).

14. The order in which we address the various issues covered under this submission follows the order of the 15 questions raised in the consultation document. For reference, the list of questions asked under each of nine chapters in the consultation document, are set out in **Appendix 1**.

INSTITUTE'S POSITION ON KEY QUESTIONS RAISED IN THE GOVERNMENT'S CONSULTATION DOCUMENT

<u>Chapter 1</u> - Is Tax Reform Required in Hong Kong?

Q1) Do you think that our existing tax base is too narrow?

15. Hong Kong's tax base is undoubtedly narrow. In 2006/07, salaries tax (including property tax) and profits tax were together forecast to contribute HK$112.2 billion or 43.6% of government revenue, 16.1% and 27.5% respectively.

16. The tax paying population was expected to drop from 1.33 million in 1997/98 to 1.26 million in 2006/07. It was estimated that over 43% of the working population would pay no salaries tax in 2006/07, the top 100,000 taxpayers would pay approaching 60% of the total salaries tax (compared with around 56% in 1997/98) and that the 1% of the working population (i.e. approximately 12,600 people) who pay salaries tax at the standard rate (currently 16%) would contribute 35.8% of the total salaries tax receipts[1].

17. In total in 2005, there were over 550,000 local and overseas companies registered with the Companies Registry. Of the 63,000 corporations that paid profits tax in 2004/05, the top 800 companies paid over 63% and the top 1300 companies (comprising 2% of corporate profits tax payers) paid 70% of total profits tax receipts.

Comparisons with international norms – OECD and Asia Pacific

18. Taxes generated from consumption of goods and services amount to 17.8% of tax revenue in Hong Kong, compared with an OECD average of around 32%[2a]; and an Asia Pacific benchmark of around 28% (12% on general consumption and 16% on

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[1] Figures extracted from the Information Pack for FS's Consultations on the 2007-08 Budget, November 2006

[2a] Consultation Document - "Broadening the Tax Base Ensuring Our Future Prosperity: What's the Best Option for Hong Kong?"

specific goods and services)[2b].

19. Tax on corporate income in Hong Kong at around 45% of tax revenues collected by the Inland Revenue Department ("IRD") is significantly higher than the OECD average of 9%[3].

20. Clearly the tax base is narrow. It is too narrow if this tax base, together with other sources of funding, cannot produce enough revenue over the medium to long term to fund Hong Kong's projected spending requirements.

Q2) Do you believe that Hong Kong needs a tax base where revenue is generated from diversified sources that are less susceptible to external shocks and cyclical economic conditions?

21. Revenue is currently generated from diversified sources although it is true that some of those sources are volatile, particularly land income, including land premiums and land-and property-related taxes, and investment income.

22. Between 1997/98 – 2004/05, tax revenue collected by the IRD represented between 55%- 65% of total government revenue (excluding an exceptional HK$120 billion transfer from the Land Fund in 2003/04). The principal sources of non-tax revenue are land premiums and investment earnings from the fiscal reserves. These are quite volatile sources of revenue. Government figures indicate that the former has fluctuated between 3% and 28% of government revenue over the past 10 years and the latter between 0.5% and 18%.

23. While revenue has fluctuated over the past ten years, this is mainly as a result of the downturn from the Asian financial crisis during the period 1999/2000 to 2002/03. The sharp increase in revenue in 1997/98 seems to have been due partly to the way in which land premiums were accounted for. What is evident is that expenditure has shown a steady rise throughout this period. So key questions are to what extent government expenditure, is fixed and what are the expenditure projections in the medium to long term.

24. The report of the Task Force (February 2002) ("Task Force Report") emphasised the need to give priority to controlling the growth of government expenditure. The Task Force also pointed out that, following the economic slowdown starting in 1997/98, the government had deliberately maintained expenditure growth above the growth in GDP. Paragraph 52 of the Task Force Report states: "This approach was consciously adopted as a **counter-cyclical fiscal measure** and justified on economic grounds". There was therefore scope to cut back spending after the downturn was over and this was subsequently done starting in 2004.

[2b] Advisory Committee on New Broad-based Taxes *Final Report to the Financial Secretary*, para.9

[3] See the Inland Revenue Department's Annual Report 2005-06. The OECD figure is taken from the Advisory Committee's *Final Report,* which quotes OECD statistics for 2000

25. While the Task Force projected budget deficits of HK$66 billion in 2001/02, $58 billion in 2006/07 and $114 billion by 2011/12, if there was no change in course, in practice, given the efforts to control expenditure, amongst other things, the budget was back in the black by 2004/05 and a surplus was achieved in both the operating and consolidated accounts in 2005/06. The fiscal reserves, which the Task Force's projected would fall to HK$104 billion by 2006/07 if no remedial action were taken, are now expected to be HK$365.8 billion by end March 2007. It may be argued that the severity of the negative effects of the Asian financial crisis and subsequent recession obscured any underlying trends. In this connection, the Task Force predicted structural changes in the property market leading to declining revenues from land and property, which had been an important source of government revenue in the preceding years. In fact, estimates for land premiums are back to the fairly steady levels achieved during 1993/4 to1996/97, before the speculative bubble of 1997/98 and the Asian financial crisis that followed shortly afterwards.

26. The Task Force also saw an increasingly unhealthy reliance on investment returns from the fiscal reserves and Exchange Fund, which reached 17.9% and 21% of operating revenue in 1998/99 and 1999/2000, respectively. It was acknowledged that this was due in part to the swelling of the fiscal reserves when the balance of the Land Fund, which had been set up as part of the handover transitional arrangements, was merged with the reserves. Nevertheless, the return on investment appears to be back to a reasonable proportion of overall operating revenue (6.2% in 2005/06 and 7.6% in 2006/07[4],). Furthermore as the fiscal reserves are in better shape than the Task Force projected, the situation of reduced returns from investments based on diminishing levels of reserves has not materialised.

27. To sum up, while there is some reliance on sources of non-tax revenue that may potentially be volatile, it is not clear that there is unreasonable reliance on these, or that the structural changes envisaged by the Task Force that would tend to undermine the efficiency of these sources of revenue, are as strong as believed at the time.

Q3) Do you think the Government should take action to reform the tax base to ensure our future growth and prosperity?

28. We may need to look at other factors, therefore, to understand why the existing tax base may not be sustainable in the long run. There may be a need to broaden the base due to:

a) structural changes that point to reductions in revenue from existing sources. For example, the aging of the population, which will result in fewer people paying salaries tax. This issue was touched on in the Task Force Report, but a more detailed analysis may be required to demonstrate the effects on revenues. On the other hand, introducing a broad-based consumption tax would tend to erode the savings of retirees, at a time when few will have built up any substantial sums in their mandatory provident fund schemes;

[4] Based on the figures quoted for "properties and investments" in the Information Pack for the FS's Consultations, in 2005 and 2006, respectively

b) increasing demands on the expenditure side, such as on health care, in view of the aging of the population, which cannot be met by achieving savings in other areas. If spending requirements are fairly rigid and there are increasing demands on expenditure, even if these additional demands can be met from growth in the economy, there may be a need for more stability in the sources of government revenue, to tide the community over any cyclical downturns. The government needs to explain its future spending requirements and forecasts more clearly;

c) the need for tax reform, to ensure that Hong Kong remains competitive. There is a clear trend in other jurisdictions to lower rates of direct taxation – profits tax and salaries tax. Some of Hong Kong's competitors also offer specific incentives, such as tax "holidays". Hong Kong cannot afford to lose its reputation as a low tax regime, and "low" is a relative term in the eyes of prospective investors;

d) in relation to Hong Kong's competitiveness there are also more indirect threats to the attraction of Hong Kong as a base for doing business in the Mainland, which may be (i) external, e.g. developments taking place in the Mainland itself, such as improvements in logistics and the movement of industry inland to cheaper areas, away from Hong Kong's hinterland in the Pearl River Delta, or (ii) internal, e.g. challenges facing Hong Kong, such as high levels of pollution. These threats tend to reinforce the need to "pull out all the stops", including tax incentives and concessions, to ensure that Hong Kong remains a magnet for overseas investors.

Chapter 2 - Broadening the Tax Base: What are our Options?

Q4) Do you agree that there are only two viable options?

29. In its Final Report to the Financial Secretary, March 2002 ("Final Report"), the Advisory Committee considered 13 possible options (in addition to a goods and services tax or GST) to broaden the tax base, assessed against eight principles or factors of good tax design, namely: (1) broadness, (2) neutrality, (3) fairness, (4) effectiveness, (5) efficiency, (6) certainty and simplicity, (7) flexibility, (8) international competitiveness and (9) revenue stability/yield. In addition, the various options were measured against the factor of broadness (see the Final Report, pp 9 – 24):

Existing taxes

(i) Increase salaries tax rate
(ii) Increase profits tax rate (including in relation to (i) and (ii), progressive rates for higher income earners, which was not specifically considered by the Advisory Committee)
(iii) Reduce allowances and deductions under salaries tax
(iv) Increase stamp duty on real property
(v) Increase rates on tenements

Other possible options examined by the Advisory Committee

(vi) Capital gains tax
(vii) Tax on interest
(viii) Tax on dividends
(ix) Tax on worldwide income of businesses and individuals
(x) General consumption tax[5]
(xi) Payroll and social security taxes
(xii) Poll tax
(xiii) Air, land and sea departure tax
(xiv) Tax on mobile telephones and signboards

30. Although the Advisory Committee reviewed items (i) to (xiv) above, in the light of recent developments, we look once again at these possible taxes as well as the additional items referred to in (xv) to (xxii) below, bearing in mind the principles and factors referred to in paragraph 29 above.

Other possible options not examined by the Advisory Committee

(xv) Increase stamp duty on stock transactions
(xvi) Selective consumption taxes (e.g., on luxury goods)
(xvii) Extension of betting duty
(xviii) Wholesale or retail sales tax
(xix) Import / export levy
(xx) Financial transactions tax
(xxi) Environmental taxes
(xxii) Surcharge on utility bills

Possible options (other than a GST) examined by the Advisory Committee

Increasing Salaries Tax and Profits Tax Rates

31. Increasing salaries and profits tax rates would not widen the tax base and would place the burden of paying the additional tax only on those currently in the tax net. All of the additional revenue would be paid by existing taxpayers. In addition, this option would not address the issue of vulnerability to cyclical economic changes and, so, would not help to stabilise the tax base.

32. Furthermore, increasing salaries and/or profits tax rates would increase reliance on direct taxation at a time when, in order to maintain or enhance competitiveness, other jurisdictions are reducing rates of direct taxation (see the table at **Appendix 2**). Our low profits and salaries tax regime has been an important feature in attracting new businesses and skilled workers and, therefore, increasing rates of direct taxes could damage Hong Kong's ability to attract investment and high-calibre employees in future.

33. Introducing progressive rates of salaries and/or profits tax, if this meant imposing a higher rate of tax on higher levels of income/profits, would, to an even greater extent, make Hong Kong less competitive.

[5] Under this heading, the Advisory Committee examined GST.

Personal Allowances and Concessionary Deductions under Salaries Tax

34. Decreasing or abolishing the personal allowances and concessionary deductions under salaries tax would broaden the tax base by drawing into the tax net some salary-earners who are currently paying no salaries tax. The existing allowances are high by international standards, due in part to the fact that during economically buoyant periods, particularly 1993 to 1995, they were increased significantly above the level of inflation. This took a large number of employees outside of the tax net altogether. With hindsight, it would have been more prudent to have given one-off and temporary concessions and benefits to taxpayers and the wider community at that time. In addition, lowering of the marginal tax rates and widening the tax bands has had the effect of reducing the number of higher earners who pay tax at the standard rate. While this trend had begun to be reversed, in recent years, with improvements in the economy, concessions made in the 2006/07 and 2007/08 budgets, have again resulted in a reversion to the previous direction. The level of income necessary to trigger higher rates of taxation (i.e., the standard rate) is also very high by international standards, especially given the comparatively low level of the standard rate. As a result of measures announced in the 2007/08 budget, a single person will need to earn in excess of HK$2.7 million per annum before he or she becomes a standard rate taxpayer.

35. However, most of the additional revenue generated from lowering the personal allowances and/or increasing the marginal rates (and narrowing the bands) would come from existing taxpayers. Thus, while reducing personal allowances would broaden the tax base, it would also increase reliance on direct taxation and would not address the fundamental concerns about the volatility of the sources of Hong Kong's revenue. Therefore, it would not be appropriate for reductions in personal allowances to be considered as the sole or primary measure to broaden the tax base.

36. Nevertheless, the Institute believes that the personal allowances should be reviewed and placed on a firmer and more rational footing. Thereafter, any increases should be linked to specific economic triggers (e.g., increases in the Composite Consumer Price Index).

37. Once a more stable and broader tax base has been developed, the objective should be to reduce rates of direct taxation, including the standard rate of salaries tax.

Increasing Stamp Duty on Transactions in Real Property

38. The Advisory Committee noted that based on 2000/01 turnover figures, increasing stamp duty on property transfers by 20% would yield an additional HK$1 billion per annum. Based on 2006/07 projections that figure would increase to around HK$1.5 billion.

39. A moderate increase in the stamp duty on property transactions, therefore, would not, on its own, provide a very significant additional yield. A much more substantial increase would make property less affordable and could

have a negative effect on the property market, which, in turn, could have a knock-on effect on other areas of the economy. Furthermore, such a measure would not broaden the tax base and could have an adverse impact on Hong Kong's competitiveness, as Hong Kong is seen as a comparatively expensive place to do business.

Increasing Rates on Tenements

40. Increasing rates on tenements had not been listed as an option in the Advisory Committee's August 2001 consultation document, but was included in the Final Report because, during the consultation period, it had been put forward as a further possible option. Increasing rates generally fared quite well against the nine criteria, although it was noted that a significant increase in rates could act as a disincentive to businesses and skilled employees staying in or relocating to Hong Kong. While noting that Hong Kong already relied more heavily on property-related taxes than OECD or Asia Pacific averages, the Advisory Committee concluded:

> *"Nevertheless, rates do provide a broadly-based stable source of revenue that is relatively less affected by cyclical movements in business profits and, to a significantly lesser extent personal incomes. Rates are very much broader-based than either profits tax or salaries tax…. The mechanism to increase rates is simple and an increase in the level of rates generates meaningful additional revenue. The Advisory Committee considers that a moderate increase in rates may be used, especially as a short-term measure, to generate additional revenue."*

41. The Final Report of the Advisory Committee states:

> *"If necessary, the Advisory Committee further recommends an increase in rates, a reduction in personal allowances under salaries tax and the introduction of a land and sea departure tax, all of which are broad-based revenue options and relatively simple to administer, to bridge the gap pending the implementation of GST."*

42. It is not clear why, having pointed out the advantages of increasing rates on tenements, the Advisory Committee saw this option only as a possible stopgap measure. Each percentage point increase in rates, which are currently levied at 5%, would generate around HK$3 billion.

43. While we would not favour a poll tax (see below) one option that in our view might merit further consideration is a surcharge on the domestic rates that could be based at least partly on the number of persons ordinarily residing at the property.

Capital Gains Taxes

44. The Advisory Committee indicated that a capital gains tax would broaden the tax base but pointed out that, as capital gains taxes are by nature susceptible to adverse economic cycles, the additional revenue yields could be expected to be volatile.

45. Capital gains taxes are the norm in many other jurisdictions. However, we believe that the absence of any capital gains taxes is one of the cornerstones of our system and key advantages that Hong Kong enjoys over other markets overseas. If such a tax were to be levied at a significant level, and to be based on the source principle, it could have a disproportionately negative effect on Hong Kong's image overseas as a business-friendly location and act as a disincentive to investment and regional share listings in Hong Kong. While, in keeping with the rest of the system, it is more likely that a capital gains tax would be levied at a relatively low rate, this could add considerable complexity to the system without necessarily yielding a large amount of revenue. To ensure fairness, provision would also have to be made for offsetting capital losses. If a capital gains tax were to be residence-based, then it would be inconsistent with the existing system, which would in itself add complexity.

46. The Institute would, therefore, not recommend the introduction of a capital gains tax in Hong Kong as a means of broadening the tax base.

<u>Taxation of Interest Income</u>

47. Although, prima facie, it has the capacity to broaden the tax base, in practice, a tax on interest income could be avoided with considerable ease and the potential migration of deposits from Hong Kong could adversely affect the monetary system and Hong Kong's development as an international banking centre.

48. We would not support the introduction of such a tax.

<u>Dividend Tax</u>

49. Under the present system, it is possible for shareholder directors of large corporations, who may be very substantial income-earners, to escape personal taxation by receiving their income primarily through non-taxable dividends. A tax on dividends would, in principle, help to bring such people into the tax net and thus broaden the personal income tax base. A dividend tax would also ensure that foreign investors in Hong Kong-listed companies would, in practice, be required to make a fiscal contribution to Hong Kong, in return for the benefits that they accrue.

50. This form of taxation could generally be regarded as being fairly broad-based given the spread of shareholdings in Hong Kong.

51. However, as the Advisory Committee noted, modern dividend taxation arrangements often provide for a comprehensive dividend imputation system, whereby the corporate tax paid on the profits from which the dividend derives is credited to the recipient. Were such a system to be deemed to be a necessary element of any dividend tax in Hong Kong, such a tax would become potentially complex to legislate and difficult to administer. Given that rates of personal taxation in Hong Kong are lower than the standard rate of corporate tax, it has also been pointed out that there would be little or no yield from a dividend tax. On the other hand, the effective rates of

corporate tax on profits may in practice be considerably lower than 17.5%, given the various sources of income that are not currently taxed in Hong Kong, including for example offshore earnings, which comprise a large part of some Hong Kong corporation's overall profits. So consideration of a dividend tax should not be excluded on this basis alone.

52. Consideration could also be given to introducing a classical system of dividend taxation without any imputation arrangement. Systems of this type continue to exist in some jurisdictions (e.g. Canada and Korea). A supposed disadvantage of a classical system is that, as the underlying profits from which dividends are declared have already been subject to profits tax, imposing a tax on dividends without any tax credit would give rise to double taxation of the same monies, albeit not in the hands of the same taxpayer. However, a degree of double taxation also occurred in relation to estate duty, for example, which, although recently abolished, was in place in Hong Kong for many years. The issue of possible "double taxation" should be considered as only one factor to be weighed in the balance.

53. It might be possible in some cases to plan around a dividend tax. There would for example be no taxation where companies elected to re-invest profits. A further, perhaps more critical, disadvantage would be that imposing a dividend tax could reduce the attraction of Hong Kong companies to investors and have an adverse impact on their ability to raise equity funds. A system of withholding tax would also need to be put in place, which would introduce an additional element of complexity. (It might incidentally give other jurisdictions a greater incentive to enter into negotiations on double tax agreements with Hong Kong).

54. On balance, while we believe that the idea of a dividend tax merits some further consideration, it may be that the disadvantages would outweigh the advantages.

<u>Tax on Worldwide Income</u>

55. The territorial source principle is a fundamental feature of Hong Kong's taxation system and an important aspect of the simplicity of the system. Taxing foreign-sourced income would represent a departure from this basic principle and should be contemplated only in the context of a fundamental review of the whole system. It would be inappropriate to consider a change of this magnitude simply as one option for broadening the tax base, on a par with, say, introducing a general consumption tax, such as a GST.

56. In any event, as the Advisory Committee noted, in order to maintain international competitiveness, credits would need to be given for any tax paid on foreign-sourced income in the country from which the income derived, and a series of double taxation agreements would need to be negotiated with trading partners. Given Hong Kong's low tax rates, the amount of additional revenue raised may not be substantial. The cost of the administrative machinery needed to effectively enforce a system of worldwide taxation could also be significant.

57. Therefore, in the absence of a wider review of the source principle, the Institute would not support the option of taxing worldwide income. We remain open-minded on the issue of whether Hong Kong should in the long-term retain a taxation system based on the territorial principle. Given that business is increasingly commonly conducted on a multi-jurisdictional basis, it may be more and more difficult to determine when profit should be considered as having a Hong Kong source, unless very detailed rules are prescribed. Certainly, there are few jurisdictions around the world that levy taxes primarily on the basis of source. However, a fundamental review of the nature of the tax system is beyond the scope of the present exercise.

Payroll Taxes and Social Security Contributions

58. Some years ago, the Institute made the suggestion that all salary earners contribute a minimum amount to the maintenance of Hong Kong's social and economic well-being. This would be a broad based tax and would help to engage the community to a greater extent by giving more people a direct and visible stake in Hong Kong's future development. At the same time, it would also provide impetus for greater financial accountability, which is to be welcomed. The Advisory Committee calculated that each 1% in the form of a payroll tax would generate $5.8 billion annually.

59. Taxes of this kind are fairly common around the world, e.g. National Insurance contributions in the United Kingdom, social security tax and Medicare in the United States, Medicare in Australia and contributions to the Canada Pension Plan in Canada. As can be seen from these examples, they are often linked nominally to specific services, such as provision of pensions and healthcare services. Generally, they involve contributions from both the employer and the employee.

60. On the downside, similarly to salaries tax measures, this would not reduce Hong Kong's dependence on direct, more volatile sources of revenue. For employers, assuming both employers and employees contributed to the levy, it would add to the cost of doing business in Hong Kong, which is already seen as relatively high. As a compensatory measure for business, a reduction in the rate of profits tax could be considered as part of any overall package involving payroll taxes.

61. As regards the mechanism itself, the business sector is now used to the operation of the Mandatory Provident Fund Scheme ("MPF") and so the mechanism would not be entirely new conceptually, which should reduce the uncertainty arising from the unknown.

62. In principle, the Institute believes that, in the absence of a general consumption tax ("GCT"), the concept payroll and social security taxes merits further examination, especially if the additional revenues derived were to be earmarked for basic community services, e.g., education and re-training and health care.

Poll Taxes

63. The Advisory Committee noted that poll taxes (which are generally charged per head of household and may depend also on property values) have not been successfully implemented in any overseas jurisdiction. Somewhat similar forms of taxation do exist elsewhere, such as the UK Council Tax, but these may be local authority charges for the use of local community services. In the absence of a similar system of local authorities in Hong Kong, a poll tax would add complexity and, as the Advisory Committee also noted, would be difficult to police in a densely-populated place with a mobile population, like Hong Kong. The existing system of property rates offers a simpler option for raising more income on a household basis and we would favour this as opposed to introducing a new form of levy in the form of a poll tax.

Air, Land and Sea Departure Tax

64. Given that departures from Hong Kong by air and also, to the Mainland and Macau, by sea are already subject to a departure tax, it is in principle reasonable and equitable to consider imposing a tax on land and sea departures generally.

65. A tax on all land and sea departures from Hong Kong could provide a further broad-based source of revenue. We note, however, that if exemptions were to be given to, e.g. businessmen, schoolchildren, etc. who cross into the Mainland on a daily or frequent basis, as has been suggested by some people, the tax would become more complex to administer, more selective and less broadly based.

66. While the Advisory Committee suggested an expanded land and sea departure tax could be seen as interfering with the exchange and communication between the economies of the Mainland and Hong Kong, we believe that if the level of the tax is kept low and the administration kept simple (so as to minimise the costs of collection and not introduce new delays at border crossings) then these particular concerns could be addressed.

67. However, with a low rate of tax, say HK$20, the yield would not be more than around HK$2 billion and, as such, would not by itself make a very substantial contribution to stabilising revenues. On the other hand, as part of package of measures forming an alternative to a GST, it could have a role to play.

68. It is worth noting that, in the context of the Institute's survey, of all the possible tax broadening options listed, a land and sea departure tax was the only option supported by an overall majority of respondents (62%).

Taxes on Mobile Phones and Signboards

69. Whilst implementing taxes on mobile telephones and signboards might pose no great problems administratively, as the Advisory Committee noted, neither type of tax would raise any substantial amount of revenue on a stand-alone basis.

70. Although imposing such taxes would be unlikely to have any material impact on Hong Kong's competitiveness from an international perspective, questions could be asked as to why select these particular areas of business. Ease of collection may be one important factor but in practice it is not clear how straightforward it would be to enforce a levy on signboards. Furthermore, these particular business activities do not obviously give rise to any direct costs to society by, for example, giving rise to pollution, which might provide a more obvious rationale for imposing a levy.

71. Given in particular the low levels of revenue estimated to be generated from these sources, the Institute is of the view that it would not be appropriate to impose such taxes.

Possible options not examined by the Advisory Committee

<u>Increasing Stamp Duty on Stock Transactions</u>

72. While the Advisory Committee noted an international trend to move away from transaction taxes, such as stamp duties, and as a major international financial centre, Hong Kong must remain aware of developments in other markets aimed at enhancing their competitiveness, we must, at the same time, not overlook the unique qualities of the Hong Kong market. Unlike most of its competitors, for example, Hong Kong currently has no capital gains taxes, no dividend tax and limited withholding taxes.

73. Given the increasing turnover on the stock market over in recent years, the result not only of the economic cycle but also of Hong Kong's status as a capital raising centre for major Mainland enterprises, in principle at least, an increase in stamp duty on stock transactions has the capacity to produce significant additional revenue. Revenue from this source and stamp duty on real property transactions in 2006/07 was originally estimated to be around HK$14.8 billion but this was revised upwards, as at 1 March 2007, to HK$ 23.4 billion. It is likely that most of this additional revenue would have derived from stock transactions. The current levy is 0.2% per transaction, paid half by the vendor and half by the purchaser. Were the transaction levy to be doubled from 0.2% to 0.4%, in principle revenue in the range of HK$10 billion – over $30 billion would be achievable, on the assumption that overall turnover would not be significantly reduced by an increase of this order.

74. Stamp duty of stock transactions is also a fairly broad based form of tax, given that there is a very active retail financial market in Hong Kong.

75. While the revenue from this source may be potentially quite volatile, with Hong Kong's growing status as a key centre of capital raising for Mainland enterprises, a higher base level of turnover than in the past can be expected to be achieved. This would suggest that, generally, stamp duty on stock transactions can be relied upon to produce consistently a significant amount of revenue, even though the absolute amount raised may fluctuate year to year.

76. Although we acknowledge that many market participants may not support an increase in stamp duty, and indeed they may advocate further reductions, the Institute believes that, in the absence of a GCT, making more use of stamp duty on stock transactions as a form of taxation merits further consideration.

Selective Consumption Taxes

77. Hong Kong already has a number of selective consumption taxes, for example motor vehicle first registration tax and duties on fuel, alcohol and cigarettes. Suggestions have been made for a broader range of consumption taxes on luxury goods. However, it is not clear how "luxury" would be defined and whether in practice it would amount to much more than a retail sales tax with an exemption for "necessities" or "non-luxury items". If it were more selective than this, it is doubtful whether the yield would be very substantial unless the rates were very high, which would be inconsistent with maintaining a low-tax policy and could harm Hong Kong's reputation as a good place to shop.

Extension of Betting Duty

78. As one type of specific consumption tax, duty is currently levied on horse-racing and betting on soccer. Betting duty is a moderately broadly-based tax, which in 2006-07 was expected to yield around HK$12 billion. In principle, greater use could be made of betting duty as a source of government income. However, the industry commonly argues that the higher the tax, the more the incentive for gamblers to use illegal gambling rings, which have virtually none of the overheads of legal gambling.

79. If the industry's argument can be verified or accepted, then there is not much scope for raising the level of betting duties.

General Consumption Taxes - Wholesale or Retail Sales Tax

80. Here we consider forms of general consumption taxes other than a GST. Single level wholesale sales taxes ("WST") or retail sales/purchase taxes ("RST") exist in some countries and have in some cases been the precursor to GST/VAT-type taxes. Retail sales taxes still apply in the United States for example. Purchase taxes applied in the United Kingdom before the introduction of a VAT and a wholesale sales tax operated in Australia before the fairly recent introduction of a GST.

81. In the 1988-89 budget, the FS spoke of the need to broaden the tax base and alluded to the possibility of a sales tax. The nature of the discussion will sound very familiar to those who have followed the recent debate on GST. The government's objective was to produce a stable and significant revenue yield at a low rate of tax, which would cause minimal economic distortion and would be simple and not costly to administer. Opponents of the proposals argued that a sales tax would adversely affect lower income earners and would therefore impose an unfair tax burden. In addition, a sales tax was not needed at a time of substantial budget surpluses. Proponents of a

sales tax, on the other hand, maintained that, amongst other things, the stability of revenues would be less vulnerable to economic cycles and that a reduction in direct taxes, as a trade off, would increase investor confidence and enhance Hong Kong's competitiveness.

82. The Hong Kong Government issued a consultation paper in 1988 seeking views on a proposal for a WST. A WST was preferred over an RST because of the fewer number of traders who would be involved and, consequently, the comparative ease of administration and enforcement.

83. The proposal envisaged the registration of all persons carrying on business in Hong Kong who sold by wholesale (e.g., manufacturers and wholesale merchants). Small businesses (i.e. those not exceeding an annual sales threshold) would be exempt. The point in the distribution chain for the imposition of the tax would be the last wholesale disposal of goods, which would generally be the manufacturer's or wholesaler's sale to the retailer. If the manufacturer or wholesaler sold direct to consumers, the tax would be levied on those sales. A system of registration would be introduced to allow registered manufacturers and wholesalers to purchase goods free of tax to ensure that tax was levied only on the final wholesale of the goods, and so prevent "cascading".

84. Ultimately due to the strength of opposition within the community, the proposal was not pursued at that time. Looking at the issue now, for various reasons, we would not favour this form of taxation. While it has some advantages – for example, as regards administration, the tax would be collected by only a limited number of remitters – there are also a number of disadvantages. Firstly, it would cover only goods and not services, which, in heavily serviced-based economy would be a significant weakness. This means it would not be as broad based as a GST and, given also the limited number of taxable entities, the tax would have to be levied at relatively higher rate than, for example, an RST or a GST in order to generate the same level of revenue. Experience overseas has indicated that there may be classification and enforcement problems. In Australia, it was also found that five main sources provided 60% of all WST revenue (motor vehicles and parts accounting for over 26% alone)[6], so it may have a relatively narrow base. As the knock-on effect of a wholesale sales tax on retail prices would be less direct and less visible than a retail sales tax or GST, there may be greater scope for incidental price increases and any impact of inflation may be less predictable. In addition, as the rate of tax would need to be higher than for a GST or an RST, this would increase the incentive to try to avoid the tax.

85. Another alternative is an RST. While an RST would be broader based than a WST, it would arguably have the disadvantages of GST without the advantages. It would require a much larger number of registered businesses than a wholesale sale tax and be administratively complex, if it were transaction based, without having the multi-stage self-checking mechanisms of a GST. Questions of regressiveness would again arise,

[6] Brian Andrew *"Hong Kong Tax Reform: A Low-rate Indirect Tax That Does Not Sacrifice Efficiency for Conformity"* Asia-Pacific Journal of Taxation (Winter 2005)

unless there were significant exemptions, which could lead to classification problems. Nevertheless, the International Monetary Fund ("IMF") notes, in a report issued in 2001, that "[a]lthough no major country now uses an RST at the national level as its preferred form of consumption tax, such taxes are still levied in 46 of the states of the United States (where they were introduced in the 1930s) and in some Canadian provinces"[7]. The IMF report also states in a footnote that "[t]he possible introduction of a federal RST has, however, been widely discussed in the United States in recent years".

86. It has been argued that an RST, charged on a presumptive basis (e.g., on the basis of flat rate on all a firm's overall retail sales, which would be subject to audit by the IRD, rather than on the basis of actual individual transactions) would be suitable for Hong Kong[8]. The argument is that an RST of this type offers a broad revenue base, can cover services and allow for a tax exemption for exports, and it would have lower administrative and compliance costs than a GST (having fewer taxing points, tax collectors and remitters). However, the scope for avoidance may be greater than with a GST and there would also seem to be significant scope for dispute between individual taxpayers and the IRD where retail sales form only a part of a firm's business. Overall, while an RST of this type might merit further consideration from a technical point of view, as regards of gaining support, it is not clear that it would be much easier for the community to accept than a GST.

87. We note in passing the assessment of the Tax Base Study, conducted as part of the research for the Advisory Committee, on an WST or RST, namely:

> "*A single stage sales tax is internationally regarded as more administratively complex, prone to tax avoidance and dispute, and not well suited to taxing services or other intangibles (which inevitably account for a greater share of economic activity over time)".*

Import/Export Levy

88. While the mechanism to collect a tax in this way is already in place (i.e. through the Trade Declaration Scheme), so the administrative cost should be very low, such a tax could be applied only to goods and not services. The base would therefore be relatively narrow. At any significant level, it would also potentially distort the market against imports in favour of locally manufactured goods. While there is now only a limited amount of manufacturing carried out in Hong Kong, so this might be less of a problem, as a new tariff, an import/export levy could nevertheless run up against World Trade Organisation rules. It could also make Hong Kong's exports less competitive. We would not favour this option.

[7] IMF *Hong Kong SAR – Policy and Administrative Issues in Introducing a Goods and Services Tax*, January 2001, pp 40-41
[8] See footnote 6

Financial Transactions Tax

89. The concept of a financial transactions tax is a novel one, which has been considered in the United States Congress. Essentially, as proposed, it is tax on transactions through financial institutions. Attached at **Appendix 3** is a Congressional Research Service ("CRS") Report (*Transaction Tax: General Overview*, December 2004), which considers this amongst other options. It would be very broad based, the collection mechanism should not be overly complex and the yield could be potentially substantial, and it would also extend to speculative activities. However, the CRS report notes that "[n]o major industrialised nation has adopted a broad-based transaction tax". Such a tax levied on all transactions through banks, etc. (with possible exemptions for transactions below a certain ceiling) would result in cascading and, more critically, it could provide an incentive for trading activities to migrate elsewhere. Under the circumstances, the risk associated with introducing such a tax in Hong Kong, even at a very low rate, would be high given Hong Kong's status as an international financial centre. Therefore, in our view, it would not make sense to further pursue this idea, which has not been adopted by other major markets.

Environmental or Green Taxes

90. There is clear international trend to impose environmental or green taxes on polluters. In our submission to the FS on the 2001 Budget, the Institute advocated that consideration be given to the introduction of green taxes on polluters and, in particular, that the feasibility study be carried out on introducing a comprehensive green tax regime. Such a regime could include specific ecological taxes, such as resource consumption taxes, taxes on non-biodegradable materials and landfill charges, as well as tax incentives for environmentally sound machinery, vehicles and systems. We have repeated this call several times in subsequent budget submissions.

91. One of the main objectives of introducing such a regime would be to encourage socially-responsible behaviour, which, in some instances, would have the effect of more efficient and potentially lower consumption, which might in turn result in a lower revenue (e.g. in the case of fuel duties). However, the experience of OECD jurisdictions indicates that environmental taxation can also provide a significant source of revenue.

92. Environmental taxes have been introduced to a varying extent in all OECD countries. According to a 2001 study on Environmentally Related Taxes in OECD countries, the revenue from environmentally related taxes averages roughly 2% of GDP in member countries[9]. In Hong Kong, in 2005/06, we estimate that environmental taxes accounted for under 1% of GDP. On the basis of a similar potential revenue yield, therefore, environmental taxes could provide a possible alternative to GST, as a measure to broaden the tax base, while also generating a positive environmental effect[10].

[9] OECD Environmentally Related Taxes in OECD Countries Issues and Strategies, 2001, p. 9

[10] Netherlands Ministry of Housing, Spatial Planning and the Environment, Directorate-General for Environmental Protection, The Netherlands' Environmental Tax on Waste Questions and Answers, p.3

93. Environmental taxes support the “polluter pays principle”, under which the costs of pollution prevention and control should be reflected in the price and output of goods and services that cause pollution as a result of their production and/ or consumption[11]. The nature of such taxes may gain more community support, given the increasing awareness of the need to enhance environmental protection, as demonstrated by the relative success of the Rechargeable Battery Recycling Programme[12] and Voluntary Agreement on Plastic Bag Reduction[13].

94. It is noted that the Environment, Transport and Works Bureau is proposing a product eco-responsibility scheme (“PRS”), a key policy tool for waste management[14]. The government has stated that the purpose of introducing a PRS is not to increase government revenue, but to implement the principle of “polluter-pays” so as to change the consumption-led lifestyle of the public[15].

95. The PRS sets out in the Policy Framework for the Management of Municipal Solid Waste considers six types of products, as listed below, with priority given to vehicle tyres and plastic shopping bags:

(i) Vehicle tyres
(ii) Plastic shopping bags
(iii) Electrical and electronic equipment
(iv) Packaging materials
(v) Beverage containers
(vi) Rechargeable batteries[16]

96. A number of OECD countries impose packaging taxes. For instance, Belgium, Denmark, Finland and Norway have taxes on beverage containers. Denmark, Korea and Norway also tax other packaging containers, with different rates for different materials used in the container[17]. According to the data from the Environmental Protection Department, 362,080 tonnes of plastic bag waste (including plastic shopping bags, plastic garbage bags and other plastic packaging bags) were disposed of at landfills in 2005[18]. If a similar duty on carrier plastic bags to that imposed in Denmark, at Euros 2.95 per kg[19] were to be imposed on Hong Kong’s plastic bag waste at 2005 levels, potentially, a revenue of around HK$10 billion could be raised. Rubber tyres are another recyclable waste on which jurisdictions such as Denmark and Finland impose taxes, at Euros 0.54 to 24.16 per tyre and

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[11] see footnote 9
[12] Environment Protection Department, Rechargeable Battery Recycling Programme Annual Report 2005-2006, pp.3-4
[13] http://www.epd.gov.hk/epd/english/environmentinhk/waste/prob_solutions/rpsb.html
[14] Legislative Council Panel on Environmental Affairs, Proposed Legislation for Implementation of Producer Responsibility Schemes for discussion on 24 April 2006, CB(1)1300/05-06(04)
[15] Environment, Transport and Works Bureau’s Press Releases and Publications, LCQ2: Green taxes, 7 June 2006
[16] see footnote 15
[17] OECD Environmentally Related Taxes in OECD Countries Issues and Strategies, 2001, pp. 65-66
[18] Environment, Transport and Works Bureau, Press Releases and Publications, LCQ11: Government policy on plastic bag reduction, 29 November 2006
[19] OECD/EEA database on instruments used for environmental policy and natural resource management, http://www.2oecd.org/ecoinst/queries/index.htm

Euros 0.4207 to 0.976 per unit respectively[20]. In 2005, Hong Kong recovered 21,000 tonnes of recyclable rubber tyres[21].

Vehicle Taxes

97. Apart from waste management, environmental taxes may be imposed in relation to transportation. Hong Kong applies ownership restraint measures such as vehicle first registration tax ("FRT") and annual licence fee ("ALF"). The estimated revenue from FRT for 2006-07 is $4billion[22].

98. While such measures generate revenue, the nature of the tax base would to some extent determine whether they result in positive environmental effects. The tax bases are commonly differentiated by the weight or engine size of cars. However, [the OECD suggests] such differentiation will generally not be a close proxy for the environmental impacts of the vehicles[23]. Tax bases that are dependent on the age of the car may also be useful, for example, in Singapore there is a road tax surcharge for vehicles over 10 years' old[24].

99. We note that, in the 2007/08 budget, the FS announced the implementation of the government's proposals to lower the FRT on environmental-friendly vehicles. While this will provide an incentive to switch to less polluting models, the impact on the overall revenue generated from this FRT is uncertain.

100. Based on the Annual Transport Digest published by Hong Kong's Transport Department, the total number of private cars registered at the end of 2005 was 388,311[25]. Some international comparative figures on motor vehicle taxes imposed on private vehicles are at **Appendix 4**.

Taxes based on fuel-efficiency

101. A different tax base may be considered: for example, the United States and Denmark levy taxes based on fuel efficiency[26]. The estimated revenue from duties in Hong Kong for 2006-07 is $6.6billion[27], approximately 47%[28], amounting to $3.1billion, of which can be attributed to duties on hydrocarbons.

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[20] see footnote 19
[21] Environmental Protection Department, Monitoring of Solid Waste in Hong Kong, Waste Statistics for 2005, p.13
[22] Information Pack for FS' Consultations on the 2007-08 Budget
[23] OECD Environmentally Related Taxes in OECD Countries Issues and Strategies, 2001, pp. 61 & 63
[24] http://www.lta.gov.sg/motoring_matters/motoring_vo_tax_pte.htm
[25] http://www.td.gov.hk/mini_site/atd/2006/eng/section3_1_en.htm
[26] OECD Environmentally Related Taxes in OECD Countries Issues and Strategies, 2001, pp. 61 & 63
[27] Information Pack for FS' Consultations on the 2007-08 Budget
[28] http://www.customs.gov.hk/eng/statistics_revenve_e.html

Electronic road pricing (ERP)

102. ERP has been under discussion on and off for almost 20 years and a good deal of work has been done by the government to test it[29]. It was opposed when it was first put forward on the grounds of infringing privacy. However, similar schemes operate successfully elsewhere. The Congestion Charge implemented in London, for example, has reduced traffic congestion and associated pollution in central London, while raising about £200 million in revenue annually (£254m in 2005/06 and £218m in 2004/05 (HK$3.8 billion and HK$3.3 billion, respectively, at current exchange rates)[30]. In Hong Kong, ERP could help to improve traffic management, reduce air and noise pollution and traffic accidents in areas where there are many pedestrians and where many people work, and also reduce the need for further road construction. The arguments favour the introduction of ERP.

Fuel duty

103. Given the bad air pollution problem in Hong Kong, it is not understandable why the duty on diesel remains at less than 45% of the duty on petrol, in the case of light diesel oil and, by special concession, less than 20% in the case of ultra low sulphur diesel. The duty is waived in the case of buses. Equalising the rates of duty at the higher level, which could be done over a period, would give incentive to the users of diesel vehicles to use them in the most efficient way possible and it would also increase government revenues.

104. Overall, while we would like to see a more coordinated and extensive approach to environmental taxation, we would not see this as offering an ideal alternative to a GCT. There is no doubt that there is potential to raise more revenue through environmental taxation, but the yield would be uncertain and the issue is complicated by the social policy objectives that would also be inherent in any system of environmental taxation. Furthermore, in order to achieve those social policy objectives it may be more effective to offset environmental taxes against other tax concessions or reductions in direct taxation as means of incentivising good behaviour. This kind of “tax shifting” approach has been adopted in other jurisdictions. Certainly, Hong Kong should not continue to subsidise polluters, but at the same time it would be risky to rely heavily on environmental taxes as a means of broadening and stablising Hong Kong’s tax base.

<u>Surcharge on Utility Supplies</u>

105. A surcharge on utility supplies, such as gas and electricity, has the merit that it can be easily calculated and conveniently collected by the utility companies on behalf of the tax authorities. If necessary the tax authorities could, for example, allow the utility companies to offset the cost of collecting the tax indirectly by arranging for the tax to be handed over at intervals, thus allowing the companies to make use of the monies for a short period of time.

[29] Transport Department, Feasibility Study on Electronic Road Pricing Final Report
[30] Transport for London’s Annual Report 2005/06 – Note 25 to the accounts – Congestion Charging

106. The possibility of levying a 1% surcharge on utility bills, e.g., gas and electricity, including the sale of electricity and gas to all commercial and industrial customers, could be considered. A tax on utilities would be broadly based, but would not at a low rate generate a large amount of revenue. Based on the published accounts of electricity and gas companies for the year ended 31 December 2005, a levy of 5% would generate tax revenue of HK$2.25 billion, while each additional percentage of tax (levied on turnover) would generate between HK$450 million and HK$475 million.

107. Whilst this may potentially affect the consumption of utilities, at a low rate, it would be unlikely to have a substantial effect and, in any event, a more economical use of energy could be regarded as environmentally beneficial. To ease the burden of the low-income sector, an exemption could be given in respect of monthly electricity and gas bills below a certain threshold (e.g., monthly electricity bills of less than $120 and gas bills of less than $60).

108. There may be some concerns regarding the sustainability of the tax base, as one aim of green taxes generally is often to reduce consumption by increasing the cost of that consumption. Thus a higher levy will lead to lower consumption and higher levies may be subject to diminishing returns.

Q5) Do you agree that a reduction in personal allowances is not a preferred option?

109. See paragraphs 34 - 37 above.

Conclusion to Part A: Possible Options (other than a GST) for Broadening Hong Kong's Tax Base

110. Having reviewed a range of options, the Institute considers that there is no option that, by itself, would be better able than a GST to meet the objectives of broadening the tax base, reducing volatility in revenues, achieving a substantial yield at relatively low rates of tax, while causing minimal economic distortions and not adversely affecting Hong Kong's international competitiveness, etc. However, if a GST is not to be pursued, there are other options that should be examined in more detail, either on their own or as part of package of measures that together could achieve a yield of a similar order to a GST. These options, which include new taxes and making more use of existing broad based taxes, are primarily the following:

- Payroll and social security taxes
- Increasing the use of rates on tenements
- Increasing the use of stamp duty on stock transactions
- Single stage retail sales tax
- Air land and sea departure tax
- Environmental or green taxes
- Surcharge on utility supplies
- Dividend tax

PART B

Broadening the Tax Base – A Goods and Services Tax

111. The answers to the following questions are predicated on the assumption that a GST is still one of the options that should be considered as a means of broadening Hong Kong's tax base. The Institute believes that this should be the case.

Chapter 3 – The Case for GST

Q6) Do you agree that GST is an appropriate option to broaden Hong Kong's narrow tax base?

112. Value Added Tax ("VAT")/GST-type taxes have been widely adopted around the world. The 1990s saw a particularly large increase in the adoption of VAT. There are now 136 countries that apply this form of taxation and it is a condition of entry into the European Union.

113. Only five countries have ever removed an existing VAT (Vietnam, Grenada, Ghana, Malta and Belize), and three of those (Ghana, Malta and Vietnam), have since reintroduced it, which suggests that it has proved to be an efficient form of taxation around the world[31].

114. In its recent report on Hong Kong, the IMF notes that, "Hong Kong SAR has amongst the most volatile revenue bases in Asia". Subsequently, the report states: "The introduction of a GST should limit the need for fiscal reserves, by providing a more stable revenue base as the population ages and by limiting revenue volatility", while noting that the extent to which it would reduce volatility would depend upon how it was implemented[32].

115. As indicated above, the Advisory Committee favoured a GST as the most suitable way of broadening the tax base without compromising Hong Kong's external competitiveness.

116. The Institute suggested, in its submission dated 29 October 2001 on the Consultation Document, *A Broader-based Tax System for Hong Kong?*, issued by the Advisory Committee, that, subject to the findings of the Task Force on the question of whether the deficits occurring at that time were structural or cyclical, a general consumption tax would be the most suitable method of maintaining and stabilising revenues. The Institute also suggested, e.g. in its Budget Proposals 2006/07, that the government should focus on broadening the tax base in Hong Kong, rather than continuing to rely on increases in direct taxes as the primary source of any future requirements for additional revenue in times of deficits.

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[31] *The Value Added Tax – Experiences and Issues*, Background Paper prepared for the International Tax Dialogue Conference on the VAT, Rome, March 15-16, 2005

[32] IMF Country Report No. 07/4, Part I, January 2008

117. GST has been implemented quite smoothly in various jurisdictions (e.g. New Zealand and Singapore). If the idea of a GST is pursued again in future, lessons should also be learned from problem implementations (e.g., Australia and Japan). The Institute pointed out that, given the differences between Hong Kong's economy and other economies, it would be important for a successful and, as far as possible, trouble-free implementation, for the government to conduct more detailed economic and fiscal modelling and forecasting, and to test thoroughly the proposed GST system. The objective would be to evaluate the revenue and other implications of introducing the system, so as to avoid any significant unforeseen effects that could have an adverse impact on its smooth implementation.

118. While some of the other broad based tax options that we have referred to above merit further study, particularly given the government's commitment to examining other options, other forms of tax, on their own, would generally not be able to match a GST in terms of the criteria specified by the Advisory Committee and referred to in paragraph 29 above. Regarding the yield, the government estimates that each one percentage point of a GST could raise around HK$ 6billion. The Advisory Committee's Final Report states in relation to a GST:

> *"Of all the options surveyed by the Advisory Committee, it is the only one that fits the primary criteria of being broadly-based and highly revenue-productive even when the tax is set at a level which, when compared with other economies, is low."*
>
> *"… the aging of the population will place an upward pressure on social security expenditure and medical and health services. The Advisory Committee has noted that many other mature taxation jurisdictions have all implemented GST (or a variant of it) to reform their tax system in the face of aging populations. With changing demographics, increasing community expectations for government services and the adverse effects on direct tax revenues of cyclical downturns in the economy, it has become increasingly untenable for governments to continue their heavy reliance on income taxes as the predominant revenue source… Taxing private domestic consumption provides an alternative form of revenue that is considerably better shielded from economic and demographic changes within the community."*

119. The Final Report includes the following recommendation:

> *"The Advisory Committee's opinion is that a GST is the only new tax with the long-term capacity to broaden the tax base which is not incompatible with Hong Kong's external competitiveness… It therefore recommends that if a need for additional revenue is identified because of structural deficits, GST should be adopted."*

120. While the Institute would not necessarily agree entirely with this statement, most of the possible alternative approaches would appear to require a mix of different measures, including new and existing taxes (e.g., utility surcharge, payroll tax, land and sea departure tax, reducing personal allowances,

relying more on rates in tenements or stamp duty on stock transactions), in order to achieve a similar objective, which would in aggregate tend to complicate the tax system more than a single solution. Furthermore, as indicated above, GST/VAT-type taxes are widely used and familiar to investors from around the world. While this is not itself an argument for introducing a GST in Hong Kong, it does suggest that, if steps are to be taken to broaden the tax base, careful thought would need to be given before to introducing other types of taxation, except very simple taxes, that may not be as familiar to overseas investors. Introducing broad based taxes that are not commonly adopted in other jurisdictions could in itself add a level of complexity to the system in Hong Kong.

121. Under the circumstances, we would recommend that, in addition to further study being undertaken of certain other of tax options, the GST option should be re-examined with a view to addressing the main concerns raised during the consultation period prior to the government's December 2006 announcement. As well as providing a fuller explanation of aspects of the proposal that were not fully explained in the consultation document, the overall strategy needs to be thought out carefully. For example, other jurisdictions that have introduced a GST/VAT may have already introduced self-assessment, which provides an impetus and framework for more systematic approach to record keeping and tax reporting. Should this be a precursor to major tax reform in Hong Kong?

122. Amongst the concerns that need to be addressed in more detail are the impact of GST (a) on low-income groups, including retirees; (b) on Hong Kong's competitiveness; (c) on the wealth gap.

123. Other concerns include (a) how to convince the community that the rate of GST would be kept low. It is noted that, in conjunction with a lowering of the rate of corporate profits tax, Singapore has recently increased its GST rate to 7%. It is not clear that Hong Kong people would be willing to accept a similar trade off; (b) what would be the real costs of compliance on businesses?

124. Greater emphasis should be placed on education and information, in the first instance; e.g., on how moving towards consumption-based taxes can serve as an encouragement to save and invest; on the greater ability they give taxpayers to choose how to spend their disposable income when compared with direct taxation. As the primary aim should not be to raise additional revenue, a GST could be introduced at a lower level than previously suggested (e.g. 3%). The commitment in the proposals to maintaining a ceiling on the rate of any GST for a number of years will be important and also to improving basic services that benefit the lower income groups.

125. Our member survey suggested quite strongly that the community wants to see more exemptions, even though we acknowledge that this will make the system relatively more complex and reduce the revenue yield. It is clear that more would need to be done to alleviate concerns over this issue.

Chapter 4 – What is GST and How Does it Work?

Q7) Do you agree that GST is preferable to RST as a form of general consumption tax?

126. A more detailed analysis may need to be conducted of the relative advantages and disadvantages of an RST and a GST- or VAT-type tax if it is decided to proceed with a general consumption tax.

Chapter 5 – A Proposed GST Framework for Hong Kong

Q8) What are your views on the proposed GST framework and design features as outlined in this chapter?

127. The Institute has previously put forward suggestions on a possible GST framework and design features in, e.g. its submission on the Consultation Document on "A Broader-based Tax System in Hong Kong?" and in its Budget Proposals 2006/07.

128. Many of the Institute's suggestions were taken on board in the GST framework and design features proposed by the government including:

- To adopt a single positive rate at the lowest end of the GST rates as adopted by other economies.

- A GST should be the credit-invoice type, i.e., collected at each stage of the chain of production and distribution.

- To adopt the "destination principle" of GST, which is used by almost all countries that have a GST as part of their tax regime, under which, imports are taxed and exports are zero-rated.

- In the interest of cost-effectiveness, the registration threshold should be set at a fairly high level, e.g., HK$5 million turnover, with an option to register below that level.

- The Institute has suggested that to provide medium to long-term predictability, the government should consider giving an undertaking not to increase the initial rate of a GST for 5-10 years. The consultation document proposes that:

  - for the first five years after GST introduction, all revenue so generated after deducting administrative costs would be returned to the community as tax relief and other compensation measures.

  - all key elements of the tax reform, once finalised and introduced, would remain unchanged for the first five years.

- To keep exemptions and zero-rated items to a minimum, so as to reduce complexities and disputes about whether particular items should qualify for special treatment. This has been a pitfall of the GST/VAT systems implemented in some jurisdictions (e.g., recently in Australia).

- To provide targeted compensations to reduce the burden on low income households.

- The Institute contemplated the provision of a tourist refund scheme – by pointing out that in a simple system, usually only exports (including tourist purchases) are zero-rated. In general, a tourist refund scheme requires initial payment of GST as part of the purchase price to the retailer, with the tourist reclaiming a refund on departure.

- The provision of an exemption for residential rental payments (to maintain parity with owner-occupied residential buildings):

  - as it is not feasible to tax the implicit rental values of owner-occupied buildings;

  - the implications for other property-related transactions should be carefully considered to ensure that the framework is suited to conditions in Hong Kong;

  The consultation document proposes to tax non-residential property and exempt residential property (both sales and rentals).

- Reduction in direct taxes such as salaries tax and profits tax to be introduced in parallel.

- To incorporate appropriate compensations for low-income households in the GST design, e.g.:

  - increases in Comprehensive Social Security Assistance (CSSA) payments;

  - annual special payments to low-wage-earners;

  - reduction or abolition of existing indirect taxes (e.g. vehicle first registration tax, hotel accommodation tax).

- The Institute suggested that the government should consider increasing the tax deduction limit for charitable donations from the current 25% of assessable income/profits to a higher level, say, 50% of assessable income/profits.

129. In addition, to ensure that there is no further narrowing of the tax base, the Institute suggested:

- undertaking a further review of specific personal allowances by reference to the adoption of a base year, with relevant allowances adjusted in line with the changes in the economy from the time (Budget Proposals 2006/07 p.16; 2005/06 p.14);

- that, in the longer term, there was an argument for the personal allowances to be reduced, either by positive action or, more gradually, by attrition (Budget Proposals 2002/03, p.33).

130. Evidence from around the world points to the importance of introducing a simple regime with a single rate, a high registration threshold, a short list of exemptions and efficient administration (so that, e.g., refunds are not delayed), in order to ensure a smooth implementation and few subsequent compliance problems.

131. In the light of the above, the Institute is broadly supportive of the framework and design features as proposed, subject to the following additional comments:

   - Rate: We support a commitment to maintaining a single low rate that would not be altered for a certain number of years. The government should be flexible on the specific rate. Our survey of members suggested that, were a GST to be introduced, a figure of no more than 3% would be more acceptable than a higher rate.

   - Registration threshold: We support a high registration threshold. However, it cannot be assumed that all small businesses with a turnover of less than the proposed threshold of HK$5 million would be able to remain outside the GST framework. If they dealt with larger GST registered businesses, they might be under pressure to register so that their trading partners could claim the input tax. Therefore, the concessions made available to small businesses that chose to register in respect of their start-up costs would be important. It should also be made clear how businesses whose turnover fluctuated above and below the threshold would be dealt with.

   - Exemptions and zero-rated items: In principle, the Institute agrees that minimising the number of exemptions and zero-rated items would reduce the administrative burden and the complexity. However, our survey of members indicated that exemptions were seen as important by a significant majority of respondents. Specifically, education, health services, food and transport came out at the top of the list of items that should be exempted. While the Institute understands the argument for keeping exemptions to the minimum, the feedback suggest that were exemptions not to be provided for such items, more would need to be done in terms of explaining to and educating the community. This is all the more so given that, under the proposals, financial services, for example, would enjoy preferential treatment while daily necessities would not.

- Import/export trade: We support the proposal for a Deferred GST Payment Scheme and Qualifying Exporters Scheme with provision for approved temporary storage areas and bonded warehouses. However, more certainty needs to be provided as to how this would work in practice.

- Managing the changeover: Much more would need to be said and done about the transition to a GST, including information on the implementation arrangements, such as pre-GST educational programmes, and pre- and post-implementation support services.

- Administration: There are a number of unanswered questions regarding the administration of GST, concerning areas such as:

  Structural issues

  - ✓ Who would administer GST within the government and how would this integrate with the existing tax administration system?

  - ✓ System requirements within the administration, training of staff, etc. and lead times

  - ✓ Investigation and enforcement powers.

  - ✓ Dispute resolution

  - ✓ Details of what would constitute a registrable entity? Would the turnover threshold be based on actual or expected turnover - in Hong Kong and outside? What would happen to the business registration system? Would GST follow the business registration system or vice versa?

  - ✓ Would self-assessment be introduced before a GST was implemented?

  Procedural issues

  - ✓ Timing of submission of GST returns? If quarterly, could a taxpayer choose to file monthly instead so as to smooth cashflows?

  - ✓ Impact of group transactions?

  - ✓ Standard methods for calculating the GST payable for partially exempt businesses (e.g. most developers) would be needed.

  - ✓ Would there be GST supplies that are “outside of the scope” (e.g. foreign investments and dividend income)?

  - ✓ Valuation problems. How would second-hand goods and part exchange/barter be dealt with?

- ✓ Would there be special retail schemes, so GST invoices would not need to be issued by all retailers to all customers?
- ✓ Detailed arrangements for the tourist refund scheme.
- ✓ Would goods sold at conventions and exhibitions/samples be exempted?
- ✓ Would there be any special arrangements for bad debt relief?
- ✓ Would Hong Kong-based banks require GST registration numbers before bank accounts were opened?

- ➢ We note the comments of the IMF that introducing a broad-based consumption tax in Hong Kong "does pose formidable administrative challenges….. Most notably, effective controls over cross-border flows of goods are currently lacking on account of Hong Kong SAR's status as a free port; and key revenue departments (i.e., the Customs and Excise Department (CED) and the Inland Revenue Department (IRD)) have no experience in administering broad-based consumption taxes. Overcoming these challenges would require the political will to reorient the mode and focus of the operations of both the CED and the IRD in a fundamental way, as well as careful and advance planning to execute such a change"[33]. How would these points be addressed?

<u>Chapter 6</u> - Households: Impacts and Offsets

Q9) Do you support providing tax relief and compensation measures for households if GST is introduced?

132. Yes. The Institute has previously suggested incorporating appropriate compensations for low-income households in the GST design (see above).

Q10) What are your views on the measures proposed in this chapter?

133. The consultation document notes the difficulty in identifying Group 2, i.e., non-CSSA low-income households. It is important that convincing assurances be given to the community that this group, including many retirees, would be properly identified and adequately compensated. It appears from the reaction of some sectors of the community that doubt remains as to whether the proposed relief for CSSA households would sufficiently offset the effects of a GST.

134. Further thought would need to be given to the package of compensatory measures, otherwise the demand for exemptions, at least in respect of basic necessities, could intensify. Consideration should be given to, e.g., the possible tax impact of the compensation measures and if they would increase the likelihood that a recipient will fall into the tax net for the first time or, as a result of other income, pay tax at a higher marginal rate. It might

[33] See footnote 8, Executive Summary of the IMF report

also be advisable to consider compensation measures for certain categories of retirees as a separate item.

135. One possible additional option for consideration, either in the context of returning funds to the public or specific compensatory measures for lower income groups, would be payments into individual MPF funds. It is the lower income groups who are likely to feel the largest impact, both as employees during their working lives and subsequently as retirees with limited means.

Q11) How do you think that Group 2 (non-CSSA low-income households) should be defined?

136. This is not an area in which the Institute has particular knowledge or expertise and we are not in a position to know what kind of data is available on individual households in Hong Kong. In principle, reference should be made to, e.g., a ceiling in respect of annual household income. One category of persons that should be included is employees earning below or just above the MPF contribution threshold, who do not qualify for CSSA payments.

Chapter 7 - Business and Other Organisations: Impacts and Offsets

Q12) Should we use the opportunity of tax reform to enhance business competitiveness in Hong Kong, by reducing existing taxes and charges on business if GST is introduced?

137. Yes. The Institute has previously suggested a number of measures, including reducing the rate of profits tax and providing for other tax offsets, e.g. concessions for regional offices and the introduction of group relief/loss relief. However, a fuller study of Hong Kong's business competitiveness in regional and global terms should be undertaken, and a clear long-term strategy developed, in which the tax system would constitute one element, to ensure that Hong Kong remains competitive.

Q13) What are your views on the measures proposed in this chapter?

Set up assistance provision

138. The Institute supports the proposal to provide assistance to small and medium-sized enterprises ("SMEs") and other organisations that voluntarily register to help meet the compliance costs associated with the introduction of GST. It is not clear however that the amount to be set aside, i.e., HK$200 million would be adequate. Under the circumstances, we believe that the government could afford to be more generous.

Indirect tax adjustments to reduce economic distortion and revitalise competitiveness

139. It is proposed to adjust existing taxes according to the principles of (a) avoiding tax on tax and (b) to ensure that for those products currently subject to high levels of indirect tax (e.g. motor vehicles and alcohol, although it is noted that the duty on the latter has been reduced significantly in the 2007/08 budget) the introduction of a GST would not lead to an increase in the total taxation on such products. In a later example, as an illustration of how tax on tax would be avoided, it is explained that the stamp duty on the sale of a (commercial) property would be applied to the GST-exclusive value of the property. However, in the example, it is proposed that both stamp duty and GST would be charged on the sale of the property, which would seem to contradict the principle of not increasing the overall level of tax.

Relief measures

140. We support the relief measures proposed in table 12 to ensure that the overall level of tax would not increase, provided these are across-the-board. It is not entirely clear, for example, what is meant by suggesting that the logistics and trade sector would be the sectors to benefit from a reduction in the motor vehicle first registration tax. We assume the proposal is not for the reduction to apply only to those sectors, which we would not support, but only that they would be the sectors, which in practice would be likely to derive the most benefit from this general measure. We agree with the proposed increase in the ceiling on deduction for charitable donations. The Institute has previously suggested such a measure to encourage more business support of charities.

<u>Chapter 8</u> - Options for Returning the Funds from GST to the Public

Q14) What are your suggestions on how to return the remaining balance of available funds to the community?

141. In principle we would support reductions in profits tax and salaries tax. However, were a GST to be introduced, it should be part of a cohesive package of tax reforms that included e.g. incentives for business and offsetting benefits for different groups of taxpayers and low income earners. At present there is arguably insufficient analysis of the affect on the middle-income group. A study should be carried out on Hong Kong's competitiveness to determine the specific form that tax reductions should take to maximise the benefits for Hong Kong's economy. There is also a case for some expenditure increase in key areas, which would benefit lower income groups, such as health services and education.

142. Our member survey indicated that there is still concern over the overall level of government spending which, in view of the reductions that appear to have been achieved over the past few years suggests, at the very least, a need for increased transparency and accountability in this area and more sensitivity

towards the views of the community in relation to major development projects. In this regard, the repercussions of the lower population forecasts revealed in the results of the recent by-census should be made clear.

143. The Institute believes that, were a GST to be introduced, the opportunity should be taken to conduct a structural review of public expenditure and revenue and, in particular, assuming less reliance would be placed on land revenues, to consider whether it is time for a change to be made to the system that perpetuates high land prices. A lower cost of land would have a knock-on effect throughout the economy. It could have a fundamental and positive impact on the cost of doing business and cost of living in Hong Kong, which could more than offset any negative impact on prices resulting from the introduction of GST.

Chapter 9 - Economic and Industry Sector Implications

Q15) What are your views on the economic and industry sector impacts of a GST in Hong Kong?

144. The Institute believes that the direct and indirect impacts of the introduction on a GST may have been underestimated to some extent. The increase in prices, assuming a GST rate of 5%, is characterised as a "one-off spike" of around 3%, which is "expected to dissipate quickly". While the long-term effect on inflation might be limited, clearly there would be some long-term price shift as many items which were previously not taxed would be taxed, although obviously the lower the rate of GST the less the change in prices. This would be applicable both to domestic consumers and tourists, although tourists should be able to obtain a partial refund for their more expensive purchases.

145. Also it is suggested there would not be an overall increase in prices of 5% because, for example, many SMEs would be outside the GST system and would not be charging GST on their output. Nevertheless, as they would not be able to reclaim the GST on their inputs, their own costs would increase and, if possible, they would want to pass on this increase to the consumer or to their trading partners. As has often been found in other jurisdictions when major structural changes have taken place in the economy, depending on market conditions at the time, some suppliers and retailers might take the opportunity to round up prices or to raise prices generally. Again, the lower the rate of GST, the less room there would be to capitalise on the changes.

146. The figures quoted for the annual costs of compliance seem quite low, but they tell only part of the story. For some businesses there would need to be a culture change and the overall cost to them should include all the start-up costs as well as ongoing administrative costs, including the preparation time required, the need for system changes (both hardware and software) and, possibly, the need for additional staff. Furthermore, average costs do not necessarily reflect the relative difficulties for individual businesses, and could be more reflective of larger, well–run, and international companies, to which

the requirements would already be familiar or at least easier to grasp and implement.

Trade, transport and logistics

147. The increased burden of the changes for importers and exporters is alluded to. On the face of it, there would need to be much greater control than there is now over the flow of goods and the border. The impact of this should be explained and discussed more clearly, particularly in the light of the rapidly growing competition from logistics operations on the Mainland.

Property and construction

148. While the GST on the sale and rental of commercial property could be reclaimed by GST-registered business, as mentioned above, GST will be another tax, in addition to stamp duty (although under the proposals, stamp duty will not be charged on the GST element) and would add to the upfront cost of commercial property, which is already high in Hong Kong. For non-GST-registered businesses, a GST in this context would add to their financial burden.

Conclusion to Part B: The GST Option for Broadening Hong Kong's Tax Base

149. The Institute believes that GST should remain an option for broadening Hong Kong's tax base and the overall pros and cons should be weighed up against other possible options once the latter have been examined more closely.

150. As regards the design details of the proposed GST system in the consultation document, in broad terms, the Institute is supportive of the framework proposed (which incorporates a number of the design features advocated by the Institute for a GST system). However, if it is decided to put forward the GST option again in the future, then a good deal more information and explanation will need to be provided and various issues will need to be addressed, which have not been covered in the current proposals or not in sufficient depth to remove the considerable uncertainties that exist. We have outlined a number of these issues above.

Hong Kong Institute of Certified Public Accountants
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